BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of FORESTHILL TELEPHONE COMPANY U-1009-C, for an Order authorizing it to issue notes in the amount not exceeding $24,901,250, and to execute a related agreement and supplemental security instruments.	Application 05-10-026 (Filed October 21, 2005)

COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON "OPINION APPROVING LOAN AGREEMENT" FOR FORESTHILL TELEPHONE COMPANY

I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

Pursuant to Rule 77.7 of the California Public Utilities Commission's (Commission) Rules of Practice and Procedure, the Division of Ratepayer Advocates (DRA) submits these Comments on the Draft "Opinion Approving Loan Agreement" (DD) by Examiner Kevin Coughlan regarding Foresthill Telephone Company (Foresthill). DRA strongly supports all of the conditions set forth in the DD regarding the acquisition and loan transaction of Foresthill. However, for reasons discussed below, DRA also recommends that the Commission conduct an audit of Foresthill in conjunction with the company's test year 2007 General Rate Case (GRC) currently underway.

II. BACKGROUND

The DD addresses a complex acquisition and loan transaction and one which presents concerns not only for Foresthill ratepayers, but also for California ratepayers.[1] Foresthill proposes to have the Commission approve a loan arrangement with the Rural Utilities Service (RUS) of the United States and the Rural Telephone Bank (Bank) in order to borrow $24,901,250. Foresthill proposes to use approximately $14.4 million for network upgrades and the remaining $10.5 million to replace a high cost interim financing arrangement used to effectuate the acquisition of Foresthill by Sebastian Enterprises, Inc. (SEI). The DD would authorize the loan agreement, certain other financial arrangements, and, on a prospective basis, approve the merger of Fortel, Inc. (Fortel), the entity used to effectuate the acquisition of Foresthill by SEI, into Foresthill.

Most importantly for Foresthill ratepayers, the DD contains several safeguards "in connection with the liability for the refinancing of the Acquisition Debt" that DRA strongly supports.[2] DRA also supports the DD's stated intent to "open an investigation into whether the [Public Utilities] Code or Commission orders were violated when Foresthill apparently attempted to encumber its assets to secure interim financing of an acquisition debt without express authority of the Commission, and, if so, whether and what penalties should be imposed."[3]

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1 In Foresthill's GRC filing submittals for Test Year 2007, the company requests $3,522,000 from the California High Cost Fund (CHCF)-A in order to earn a 10% return on its investment. In prior years 2004 to 2006, the company neither requested nor received any financial support from the CHCF-A according to their annual advice letter filings. Accordingly, at least in part as a result of this transaction, California ratepayers may now have to pay an additional $3.5 million for Foresthill because the CHCF-A is funded by an all-end-user surcharge assessed on consumers' bills for intrastate telecommunications services.

2 DD at p. 15.

3 DD at pp. 1-2.

III. DISCUSSION

A. Acquisition

The DD recounts the complex history of the acquisition that forms the framework for the loan requests.[4] DRA agrees that a separate investigation of the ownership transfer of Foresthill to SEI via Fortel -- the latter disappearing with its merger into Foresthill -- is appropriate. As the DD notes, "At some point, SEI formed a subsidiary named Fortel, a California corporation, and used Fortel to purchase the stock of Foresthill."[5] The DD adds that the notification to the Commission that ownership of Foresthill had been legally transferred to SEI "did not mention the merger of Fortel into Foresthill, nor did it mention any encumbrance of Foresthill's assets or any liability assumed by Foresthill as a result of the merger."[6] Accordingly, DRA agrees with the DD that a separate investigation of these transactions is certainly warranted.

B. Loans

The two components of the proposed $24 million loan agreement with RUS and the Bank also raise questions. The construction budget proposed by Foresthill is approximately $14,401,250.[7] The remaining balance, some $10.5 million, is to be applied to refinancing the Acquisition Debt incurred when Foresthill was purchased from its original owners, the Hoeper family.[8]

In view of the pending GRC, the DD does not make a finding concerning the reasonableness of Foresthill's proposed construction program.[9] The Foresthill 4-year

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[4] DD at pp. 2-4.

[5] DD at p. 3.

[6] DD at p. 4.

[7] DD at p. 8.

[8] DD at pp. 2, 9.

[9] DD at p. 9.

construction budget[10] anticipates expenditures in *the current year* of $5.2 million, over a third of the four year total. The current year is over half gone. Given that the DD finds that CEQA does not apply to Foresthill based on the unfinished nature of the company's construction plans,[11] the Commission should question how it will be possible to spend over one-third of a construction budget in less than half a year without actual plans in place or environmental approvals and permits being obtained. This situation should be a red flag for the Commission.[12] Furthermore, while the majority of the budgeted expenses could be attributed to the usual construction work-in-progress (CWIP) high front-end costs, there are no explanatory details provided nor commented on in the DD. Accordingly, the Commission should carefully examine the company's proposed expenditures for their construction program in 2006 and 2007 and audit their books in the pending GRC to clarify in particular the extent to which the firm has become leveraged due to the takeover.

C. Impact on Rate Base

In their initial application to the Commission, the new owners stated that their actions would not increase the rate base from which a future guaranteed rate of return would be generated. Specifically the new owners stated:

> This transaction is a sale of stock and not a sale of Foresthill's assets. There will be no step up in the rate base authorized by the Commission in Foresthill's most recent general rate case as a result of the transfer in ownership. There is no impact on Foresthill's assets. Therefore, ratepayers will not have to fund through their rates any stock acquisition premium associated with this transaction. They will still benefit from the use and retention of assets that were in place before the transfer and will also receive the benefits of the transaction without being

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[10] Id.

[11] DD at pp. 18-19.

[12] In Foresthill's GRC for test year 2007, the Commission should examine whether the construction budget is being heavily loaded in the first year for reasons other than the need to upgrade the company's network.

> exposed to any of the costs.... Although the transaction itself will not result in any changes in rate base, and should result in the same or reduced expense, the anticipated investments to upgrade facilities is substantial. Sebastian fully expects that it will be allowed to earn a return on this additional investment.[13]

Yet, in the test year 2007 GRC Advice Letter, Foresthill states:

> FTC [Foresthill Telephone Company] seeks significant increases in its revenue base in order to establish a reasonable rate of return on its operations. The Company experienced a significant net income loss in 2005 and is projected to have net income losses in 2006 and 2007 without support from the CHCF-A fund. With this filing, FTC requests CHCF-A support in the amount of $3 million. This will establish a return on investment of 10% for the 2007 test period.[14]

Given the fact that the company will apparently need to seek additional sources of revenue, with the attendant risk to ratepayers, the importance of the conditions the DD would apply to protect ratepayers is evident. For the network upgrades discussed in the construction budget, Foresthill ratepayers are likely to get service improvements in physical plant. These include:

- significant loop investments in 2006- 2007 including cable, fiber, and new electronics;
- new fiber interconnection with AT&T; and
- a new softswitch to replace the circuit-switch currently in use.

But these network upgrades are dependent upon the settlement of the interim debt incurred to finance the acquisition of Foresthill by SEI. The crux of this matter is explained in the DD:

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[13] Application of Sebastian Enterprises, Inc. (A.05-03-008) for Acquisition of Control, dated March 8, 2005. The DD on page 3 also notes that D.05-05-045 stated that "approval of the transfer of control will not result in any changes to Foresthill's rates, tariffs, or manner in which service is provided."

[14] Advice Letter General Rate Case Filing, Test Year 2007 (AL 263A), p. 1.

> Foresthill has arranged to get low-cost financing from the RUS and the Bank for its construction program, but this financing is dependent on the refinancing of the Acquisition Debt and the Acquisition Debt being a liability of Foresthill. Thus, we have to balance the desirability of approving a construction loan from the RUS and the Bank with the disadvantages of having the refinancing of the Acquisition Debt be a liability of Foresthill, the regulated utility. Foresthill's assumption of the Acquisition Debt is potentially problematic because (i) ratepayers are at risk of having to pay off the loan and (ii) there is a risk that the operating assets of Foresthill could be foreclosed upon in the event of non-payment, which could also adversely affect Foresthill's customers. [15]

DRA agrees with the conclusion the DD reaches regarding this dilemma:

> We conclude that the benefit to Foresthill and its customers of infusing low cost capital and the eventual service enhancement to its subscribers outweigh the disadvantages of having Foresthill being liable for the Acquisition Debt, particularly as we can ameliorate some of those disadvantages by placing conditions on the financing authority. In particular, *our conditions will prevent any ratepayer liability for retiring the debt.*[16]

DRA strongly agrees with Conclusion of Law 8: "The shareholders of Foresthill, not its ratepayers, should be responsible for the payment of the principal and interest on the refinancing of the Acquisition Debt."[17] Therefore, the conditions the DD imposes are both appropriate and necessary to protect ratepayer interests.

D. Financials and Need for Audit

On pages 6 and 7, the DD shows the balance sheet for Foresthill as of December 31, 2004. It has a capital structure of 17% debt and 83% equity and, thus, it is not highly

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[15] DD at p. 13.

[16] DD at p. 13; Emphasis added.

[17] DD at p. 22.

leveraged. However, the independent auditor's report, accompanying the financial statements, states that the financial statements were not audited, but merely compiled. Therefore, the independent auditor could not render an opinion with respect the accuracy of the financial statements, including the accuracy of the capital structure as reflected in the Balance Sheet for 2004.

The Balance Sheet for Foresthill, as of December 31, 2005, shows a capital structure of 8% debt and 92% equity.[18] This means that there is hardly any debt in the overall capital structure, which would allow financing at attractive rates. The DD appropriately notes that the financial statements for 2005 also have not been audited and are therefore not final.

Between December 2004 and December 2005, Foresthill's current assets decreased by approximately $2 million while investments increased by $3.4 million and net telecommunications plant increased by $629,823. At the same time, Foresthill stockholder's equity increased by $2.9 million from 2004 to 2005. The DD, however, does not comment upon these changes, which seem significant and abrupt for a small company such as Foresthill. Moreover, depending on the details of the above increases and decreases in Foresthill's balance sheet components, the requested rate base for year 2007 is affected. Specifically, if the decrease in current assets is based on a decline in materials and supplies, the rate base is reduced. Conversely, with the increase in net telecommunications plant, the rate base is inflated.

Additionally, the DD states that the net income for year 2005, as reflected in Foresthill's application, is $266,449.[19] This is contrary to Foresthill's GRC test year 2007 Advice Letter filing which states:

> Operational Account information through August 2005 was audited by Moss Adams [CPAs], input into the accounting system, and the data scrubbed to eliminate any issues in the

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[18] DD at p. 8.

[19] Id.

> booked numbers provided by the previous owners. These numbers were combined with August through December information to develop end of year information. Although unaudited at this point, the net result indicates a net income loss for Foresthill of over ($600.000) for 2005.[20]

Furthermore, the capital structure shown for Foresthill, as of December 31, 2005, reflects 73.3 % debt and 26.7% equity, before the $24,901,250 loan, and a pro forma capital structure of 86.4% debt and 13.6% equity, after consummation of the loan.[21] The DD makes a reference to the capital structure shown as part of Exhibit C to the revised Application, as recorded. But this does not comport with the recorded Balance Sheet at December 31, 2005, shown on page 16 of the DD.

In summary, the DD describes: (1) inconsistencies in the capital structures reflected in the Balance Sheet as of December 31, 2005, to the "capital structure shown as part of Exhibit C to the Application (revised),"[22] as described above; (2) large swings in assets, investments, and stockholder equity in the Balance Sheet from December 31, 2004 to December 31, 2005; and (3) large swings in net income from 2004 of $296,689 to a net loss of over ($600,000) for 2005. These inconsistencies warrant an audit to be performed as part of the 2007 GRC. The company's cooperation with and financing of an audit should be an additional condition of the Commission's approval of these transactions.

IV. DRA's PROPOSED ORDERING PARAGRAPHS

DRA proposes and requests that the following ordering paragraphs be added to the the DD:

1. The Telecommunications Division (TD) shall perform an audit of Foresthill as part of the company's GRC for test year 2007.

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[20] AL 263A p. 2.

[21] DD at p. 16.

[22] Id.

2. Foresthill shall fully cooperate with TD in their performance of the audit.

3. The audit shall address compliance with the Commission's rules, orders, decisions, and policies.

V. CONCLUSION

While DRA supports all of the conditions set forth in the DD regarding the acquisition and loan transaction of Foresthill, we also recommend that an audit be conducted in conjunction with company's 2007 GRC, already underway, for the reasons set forth above. With the modifications described in these comments, the DD should be adopted.

Respectfully submitted,

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June 26, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES ON "OPINION APPROVING LOAN AGREEMENT" FOR FORESTHILL TELEPHONE COMPANY** in **A.05-10-026** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to an e-mail message to all known parties of record to this proceeding who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on June 26, 2006 at San Francisco, California.

/s/ ALBERT HILL

Albert Hill

N O T I C E

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